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Merrill Lynch

An Investor's Guide to the 1986 Tax Reform Act

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Introduction

After more than eighteen months of serious debate and negotiation, the Tax Reform Act of 1986 is a reality. Although the tax code remains rather complex, the new law achieves the President's goal of creating a simpler, fairer and more economically efficient tax system for the majority of the American people.

In terms of simplicity, the new law reduces the number of tax brackets from 14 to 2. In addition, the distinction between ordinary income and capital gains disappears, which eliminates the holding period rules. The new law also increases the standard deduction, which means fewer taxpayers will itemize deductions, generally easing the tax preparation process. The objective of fairness is accomplished, in part, by provisions that strengthen the minimum tax and restrict deductions from tax shelters, ensuring that taxpayers with similar levels of income pay similar amounts of tax. The drastic reduction of tax rates should mean a more efficient tax system, which will result in investment and business decisions being made on the basis of economic merits rather than tax benefits.

For the investor, the legislation presents an opportunity to profit by adapting investment strategies to take advantage of the new tax structure. In this brochure, we explain the highlights of the new law and offer you guidance on how to take advantage of tax reform.

Because the major changes are effective beginning January 1, 1987 (except as stated otherwise), there are many strategies that should be implemented prior to the end of 1986. The "1986 Strategies" described in this brochure suggest ways to reduce current tax liabilities, while the "1987 Planning Recommendations" provide direction for future planning.

We suggest you use this brochure only as a guide. Tax planning varies greatly with individual circumstances, and we cannot act as your tax advisor. While each of our strategies can be beneficial, you should examine each one with your tax advisor to determine whether it is suitable for you.

Tax Rates/Deductions and Allowances

Individual Tax Rates

- Tax rates will be reduced, lowering the maximum tax rate from 50% to 38.5% in 1987, and 28% in 1988 and future years (see Appendix for rate schedules).

Allowances and Deductions

- Allowances for the standard deduction and personal exemptions will be increased (see Appendix for amounts).

The following tax benefits will be eliminated or reduced:

- The $100 dividend exclusion ($200 for joint returns) will be eliminated.
- The two-earner deduction, which allowed working couples to deduct up to $3,000 of earned income, will be eliminated.
- State and local sales taxes will no longer be deductible.
- Most miscellaneous itemized deductions, such as investment counseling expenses, tax advisory fees, professional dues and subscriptions, and other investment expenses will only be deductible to the extent that they exceed 2% of adjusted gross income.

1986 Strategies*

To take advantage of lower future tax rates, postpone income into 1987 and thereafter as follows:

- Transfer funds from vehicles that pay income in 1986 (for example, money market accounts) into short-term discount obligations (for example, Treasury Bills, Certificates of Deposit) which do not pay interest in 1986 and mature in 1987.
- Purchase an annuity or life insurance policy for tax-deferred growth.

To get the greatest advantage from deductions, accelerate them in 1986, while they are worth up to 50¢ on the dollar, as follows:

- Prepay anticipated medical expenses, charitable contributions, state and local income and property taxes, and miscellaneous itemized deductions.
- Make larger consumer purchases in 1986 while sales taxes are still deductible.
- Consider prepaying any 1987 charitable commitments with appreciated securities held long-term.
- Consider establishing a charitable trust before year-end to create deductions in 1986.

- To simultaneously increase 1986 deductions and postpone income into 1987, consider purchasing on margin *non-discount* corporate or U.S. Government bonds after the final 1986 interest payment date.

*Investors subject to the alternative minimum tax should consider accelerating income in 1986 and deferring deductions until future years (see page 10 for details).

1987 Planning Recommendations

- Because 1988 tax rates will be even lower than 1987 rates, it would be appropriate to postpone income into 1988 and thereafter, and to accelerate deductions in 1987.

Q & A About Tax Rates

Q. At what rates will income earned in 1987 and 1988 be taxed?

A. The 1987 tax rates, which are displayed in the Appendix, are based on an average of 1986 rates, adjusted for inflation, and the lower rates enacted under the Tax Reform Act of 1986. Thus, the 1987 tax rates will be less than the rates in effect for 1986. In 1988, when the new rates are in effect for the whole year, rates will be lower still.

Q. Will the maximum individual tax rate ever exceed 28% in 1988 and future years?

A. Yes, certain taxpayers will be subject to a 33% marginal tax rate on a portion of their income. Under the old law, the tax system was designed so that all individuals would benefit from the lower marginal tax brackets. The new tax law eliminates the benefit of the 15% tax rate by imposing a 5% surcharge on taxable income between $71,900 and $149,250 for married couples ($43,150 and $89,560 for single taxpayers). The net effect of this surcharge is that married couples with taxable income over $149,250 ($89,560 for single taxpayers) will pay a flat 28% tax on their income.

Q. How will reduced tax rates affect the investor?

A. As tax rates are reduced, the after-tax yield on income from taxable investments will increase. For instance, if an investor formerly in the 50% tax bracket purchased a 10% corporate bond, the after-tax yield was only 5%. However, if the investor is now in the 28% bracket under the new law, the after-tax yield rises to 7.2%. The reduction of tax rates also reduces the value of tax deductions. For example, if an individual in the 50% tax bracket donates $10,000 to a charity, a tax savings of $5,000 is realized. If the contribution is made in 1988, when the maximum tax rate is 28%, the same $10,000 contribution results in a tax savings of only $2,800. Thus, if you are considering making a charitable contribution or other tax-deductible payment, such amount should be paid in 1986 to maximize your tax savings.

Q. What tax planning strategies are recommended for 1986?

A. It is usually wise from a tax perspective for investors to accelerate losses in order to reduce current taxes and defer gains until the following year. This strategy is even more beneficial in 1986 because tax rates will be lower in the future. This year, your deductions will offset income taxed at a higher rate, and your tax liability on the income earned next year will be reduced when your tax bracket is lower. In addition, you will have the use of money you would have otherwise paid in taxes for another full year. Refer to the 1986 strategies on this page for recommendations on ways to postpone income and accelerate deductions.

Q. Should investors continue to purchase municipal bonds after 1986?

A. Yes, if they are in the 28% tax bracket. Although the reduction of tax rates will reduce the after-tax advantage of municipal bonds, many municipal bonds will still provide a greater return, on an after-tax basis, than taxable investments. In order to compare what a taxable bond would have to yield to equal your tax-free yield in a municipal bond, you can use the table below.

Q. Will municipal bonds issued in the past continue to be exempt from Federal income tax?

A. Yes. Interest earned on municipal bonds issued prior to August 8, 1986 will remain tax-free. However, interest earned on *certain* private purpose bonds issued after August 7, 1986 will no longer be exempt from taxes. Furthermore, the tax-exempt interest on other private purpose bonds issued after August 7, 1986 will become a tax preference item in 1987 and thereafter for alternative minimum tax purposes. So, investors subject to the alternative minimum tax should avoid these bonds.

Neither of these rules would affect municipal bonds issued for public purposes, such as roads and schools, or those issued on behalf of non-profit organizations, such as private hospitals and universities. Your Merrill Lynch Financial Consultant will be able to inform you whether a potential municipal bond investment will provide you tax-exempt interest income.

The Tax-Exempt Edge of Municipal Bonds

To compare what a taxable bond would have to yield to equal your tax-free yield from a municipal bond, first, find your marginal tax bracket. Then, at the top of the table, find the yield of a tax-exempt bond you might buy and read down until you find what percentage interest you would have to receive from a taxable security to equal that yield. If the yields of taxable securities that you might buy are lower than that figure, then they won't provide you with as much spendable income as the municipal bond would. If the yields are higher than that figure, they will provide you with more spendable income. You should also consider the effect of your state and local income taxes in making the comparison between taxable and tax-exempt securities.

Based on 1987 Income Tax Brackets

% income tax bracket	Tax-exempt yield			
	6½%	7%	7½%	8%
11%	7.30	7.86	8.42	8.98
15%	7.64	8.23	8.82	9.41
28%	9.02	9.72	10.41	11.11
35%	10.00	10.76	11.53	12.30
38½%	10.56	11.38	12.19	13.00

Based on 1988 Income Tax Brackets

% income tax bracket	Tax-exempt yield			
	6½%	7%	7½%	8%
15%	7.64	8.23	8.82	9.41
28%	9.02	9.72	10.41	11.11
33%*	9.70	10.45	11.19	11.94

*If 5% surcharge applies.

Capital Gains and Losses

Major Changes

- Maximum tax rate on long-term capital gains increased from 20% to 28%.
- Maximum tax rate on short-term capital gains reduced from 50% to 38.5% in 1987, and 28% in 1988 and future years.
- Maximum tax rate on regulated futures contracts will remain close to 32% in 1987, and will be reduced to 28% in 1988.
- All net capital losses will offset ordinary income dollar-for-dollar up to $3,000 per year.
- Installment sale treatment is repealed for sales of publicly-traded property entered into after December 31, 1986.

1986 Strategies

- If considering the sale of appreciated securities held long-term, sell in 1986 to minimize tax liability.
- If considering the sale of appreciated securities held short-term, lock in gains but postpone taxation until future years via installment sales, selling short against the box or utilizing certain options strategies.
- Realize short-term losses before year-end to take deduction against income taxed at higher 1986 rates.
- Postpone realizing long-term losses until 1987 when they will be fully deductible, dollar-for-dollar, against ordinary income.

1987 Planning Recommendations

- Because 1988 tax rates will be even lower than 1987 rates, the strategies appropriate for 1986 are also recommended for 1987.

Q & A About Capital Gains and Losses

Q. Should an investor sell appreciated securities held long-term before the end of 1986?

A. If investors are considering selling appreciated securities held long-term in the near future, selling prior to the end of 1986 enables them to take advantage of the current lower long-term capital gain tax rates. Although the decision to sell should not be based solely on the tax increase, investors should be aware that the increase in 1987 from 20%, or less, to 28% represents an increase of 40%, or more, in tax liability. Investors may also consider selling appreciated securities held long-term to take advantage of the 20% tax rate in 1986, and then re-acquire the security if they wish to continue to maintain the investment.

Q. How will capital gains be taxed in 1987 and future years?

A. In 1987, net long-term capital gains will be subject to a maximum tax rate of 28%, even if the taxpayer is in a higher marginal tax bracket. In 1988 and future years, all

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capital gains, short-term and long-term, will be taxed in the same manner as other types of income, subject to the 28% maximum tax rate. However, these amounts would be subject to the surcharge, and could be taxed at a 33% marginal tax rate.

Q. With tax rates to be reduced in 1987 and 1988, how can investors lock in their short-term gains this year, 1986, but defer taxes until future years?

A. Investors can lock in short-term gains in 1986 but defer taxes until future years either through an installment sale or by selling short against the box. Through an installment sale, an investor can sell large blocks of appreciated stock and receive interest-bearing notes in payment. This strategy locks in the sale price but defers taxes until payments are received. Thus, investors can defer taxes until future years, which may lower their tax bill, and at the same time, they earn interest on money that would otherwise be paid in taxes. Remember, however, that installment sale treatment is only available for installment sales entered into before January 1, 1987.

The technique of selling short against the box means that an investor sells short the same number of shares they own of the same stock. The original short-term capital gain is not taxed until the short position is covered by delivering the stock sometime in the future.

Alternatively, an investor can buy put options on the stock, if they are available. A put option gives the buyer the right to sell a specified number of shares of the underlying common stock at a specified price within a specified period of time. For the cost of the put, an investor can lock in capital gains and can still participate in any material increase in the stock's price, which cannot be accomplished by selling short against the box.

Q. Should investors with unrealized capital losses consider selling before the end of 1986?

A. Investors who have unrealized net *short-term* capital losses should consider selling by December 31, 1986, so that the loss may be deducted in 1986 against income taxed at higher rates than in 1987. If an investor has unrealized net *long-term* capital losses, those losses will be more valuable in 1987 and thereafter, when they will be fully deductible, dollar-for-dollar, against ordinary income. Under current law, it takes $2 of net long-term losses to offset $1 of ordinary income. Remember, however, that capital loss deductions are limited to capital gains plus $3,000 under both the current and new laws.

Investors should also consider tax loss swaps to maximize their short-term capital loss deductions for 1986.

However, if a security is sold at a loss and the same or substantially identical securities are repurchased within 30 days before or after the sale, the loss will be disallowed under the wash sale rule. Rather than risk the price fluctuations of the next 30 days, investors can reinvest in securities that are not substantially the same, such as securities of another company in the same industry. You can also swap bonds of the same issuer if the bonds are not substantially identical.

One alternative to tax loss switching is to double up on the same securities, wait 31 days and then sell the securities that were acquired first. Of course, doubling up may expose an investor to the risk of a decline in price.

Retirement Planning

Individual Retirement Accounts

- $2,000 IRA deduction ($2,250 for spousal IRAs) retained for all employees not covered by another retirement plan.
- $2,000 IRA deduction for employees covered by another retirement plan retained if adjusted gross income is less than $40,000 ($25,000 on single returns).
- IRA deductions phased out for individuals with adjusted gross income between $40,000 and $50,000 ($25,000 and $35,000 on single returns).
- Non-deductible contributions allowed for employees not entitled to deduct IRA contributions.
- Earnings on non-deductible contributions not subject to income tax until withdrawn.
- Interest on debt incurred to fund an IRA will not be deductible.

Retirement Distributions

- Ten-year averaging formula is generally replaced by five-year method.
- One lifetime election for distributions received after age 59½, and for recipients who were 50 or older on January 1, 1986.

Other Provisions

- Elective deferrals to 401(k) plans will be limited to $7,000 annually.
- Elective deferrals to 403(b) plans will be limited to $9,500 annually.
- Elective deferrals to certain Simplified Employee Pension (SEP) plans will be permitted up to $7,000 annually.

1986 Strategies

- Maximize deductible retirement plan contributions before limitations become effective.
- If you are self-employed or own a business, consider establishing a Basic™ retirement plan before the end of your taxable year or a Simplified Employee Pension (SEP) plan before April 15, 1987.
- If you were under 50 on January 1, 1986, and are considering a career change or retirement, accelerate the receipt of lump sum distributions if you want to take advantage of ten-year averaging in 1986.

1987 Planning Recommendations

- Maximize retirement plan contributions, whether deductible or not, to optimize tax benefits.

Q & A About Retirement Planning

Q. Should employees who cannot deduct IRA contributions continue to make the maximum contributions to their plans?

A. Yes. Even those who cannot deduct IRA contributions should make non-deductible voluntary contributions because the earnings on those contributions will be exempt from taxes until distributed. By making these contributions, workers will earn interest on their original contribution, and on the accumulated earnings, including amounts that would otherwise be paid in taxes.

Q. How will individuals who are not covered by another retirement plan calculate IRA deductions after 1986?

A. Individuals who are *not* covered by another retirement plan will be allowed to deduct IRA contributions, up to present law limitations ($2,000 for individual and $2,250 for spousal IRAs) regardless of their level of income.

Q. How will individuals who *are* covered by another retirement plan calculate IRA deductions after 1986?

A. Married couples who have joint adjusted gross income under $40,000 ($25,000 on single returns) may deduct IRA contributions subject to present law limitations, even if covered by another retirement plan. If adjusted gross income is between $40,000 and $50,000 ($25,000 and $35,000 on single returns), deductions for IRA contributions are allowed on a pro rata basis. For example, a married worker with adjusted gross income of $45,000 would be limited to a deduction of $1,000, plus $125 on behalf of a nonworking spouse. Once adjusted gross income equals or exceeds $50,000 ($35,000 on single returns), IRA deductions for employees covered by another retirement plan are not permitted. For married couples filing separately, deductions for IRA contributions are phased out as adjusted gross income ranges between $0 and $10,000.

Q. When are employees considered to be covered by another retirement plan?

A. Employees are considered covered by another retirement plan if they are active participants in any tax-favored retirement plan, such as a pension plan, a profit-sharing plan, a stock bonus plan, a SEP plan, a Section 401(k) plan, or a Section 403(b) plan. For purposes of these rules, it makes no difference whether or not an employee is vested.

Q. Are there any other products that allow an investor to "shelter" income?

A. Yes. Many life insurance and annuity products offer significant tax advantages. The primary tax benefit of insurance and annuity contracts is that the increase in cash value, known as the "inside build-up," is not subject to current tax. In this respect, these products are similar to retirement plans in that they enable contract owners to defer taxes on earnings in their contracts until such amounts are distributed. Thus, individuals will earn income on their original payment, on the accumulated earnings, and on amounts that would otherwise be paid in taxes. And, in the event the proceeds are distributed in the form of life insurance benefits, such amounts will be income tax-free to the beneficiary.

The other important benefit of life insurance is that the individual has the ability to borrow against the cash surrender value (within reasonable limits) without causing any negative tax consequences. Therefore, the funds are available on a tax-free basis if desired by the individual. This benefit is not available for annuities.

Q. How do the changes to the ten-year averaging provisions affect a person receiving a lump-sum retirement distribution after 1986?

A. If an individual was 50 or older on January 1, 1986, it makes no difference whether a lump-sum distribution is received in 1986 or thereafter because, under the transitional rules, whenever they receive a lump-sum distribution, they will be allowed to choose between five-year averaging at the new tax rates or ten-year averaging at 1986 rates. However, if an individual was under 50 on January 1, 1986, they will not be able to choose ten-year averaging after 1986. Therefore, individuals who were under 50 on January 1, 1986, who desire to elect the ten-year averaging method should consider this factor in making their year-end employment decisions. All individuals, regardless of age, will continue to be allowed to roll over any lump-sum retirement distributions into an IRA instead of using five or ten-year averaging.

Q. Does the new legislation increase the attractiveness of any particular type of employer retirement plan?

A. Yes, for certain small employers, the Simplified Employee Pension (SEP) plan will become more attractive than before. This new incentive allows employees who participate in a SEP to have elective deferrals up to $7,000 made on their behalf. However, this incentive is available only if the employer has no more than 25 employees *and* at least 50% of the employees elect to have amounts contributed to the SEP.

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Interest Expense

Major Changes

- Mortgage interest deductions permitted only on a primary and one secondary residence.
- Mortgage interest deductions allowed on loans only up to purchase price of property plus improvements, unless the loan proceeds are used for educational or medical expenses.
- Investment interest deductions limited to net investment income.
- Deductions for consumer interest will be eliminated subject to transitional rules.
- Interest on debt incurred to fund an IRA will no longer be deductible.

1986 Strategies

- Maximize interest deductions before limitations become effective.
- Make sure that sufficient credits exist in your margin account so that you can deduct all interest expense.

1987 Planning Recommendations

- Monitor investment interest expense and net investment income to ensure current deductions.
- Borrow for investment purposes (if you have sufficient net investment income), and pay for consumer items with cash.
- Consider refinancing your mortgage to pay off consumer loans and educational expenses.

Q & A About Interest Expense

Q. What types of interest expense will be subject to limitation in 1987 and thereafter?

A. Business interest expense will remain fully deductible. Mortgage interest on first and second homes, including amounts paid on Equity Access™ accounts, will remain deductible as long as the mortgage loan does not exceed the original purchase price, plus the cost of improvements. The interest on mortgage loan proceeds above this limit to finance home improvements, education and medical costs will remain fully deductible. Investment interest expense (for example, margin interest) will only be deductible up to net investment income. Consumer interest (for example, automobile loans, student loans and credit card interest) will no longer be deductible, subject to the transitional rules. Also, interest on debt incurred to fund an IRA will no longer be deductible.

Merrill Lynch has several different accounts that can be useful in the management of credit, which will be extremely important under the new tax law. Our Cash Management Account® financial service, our Capital Builder™ accounts, regular margin accounts, and our Equity Access™ accounts provide ways to access credit at favorable terms and through means that would retain tax deductibility under the new law. Your Merrill Lynch Financial Consultant can give you more information about these accounts and the benefits they offer.

Q. What is meant by "net investment income"?

A. Under the new law, net investment income is the excess of investment income over investment expense. Investment income includes income from interest, dividends, rents, royalties, gains and losses from the sale of investment property, and net losses from limited business interests allowed under the tax shelter phase-in rules (for example, limited partnerships or S corporations in whose activities the taxpayer does not materially participate). See page 9 for details. Investment expense includes amortization of bond premiums and all expenses, other than investment interest expense, directly connected with the production of investment income.

Q. How will an investor determine the amount of interest expense that will be deductible after 1986?

A. In future, all investment interest expense will be deductible only up to the extent of net investment income. Under a transitional rule, in 1987, 65% of excess investment interest expense that would have been allowed under pre-1987 law remains deductible. This percentage is decreased to 40% in 1988, 20% in 1989, and 10% in 1990. In 1991 and thereafter, excess investment interest expense would not be deductible. However, any excess investment interest not deductible in any year because of this limitation may be deducted in future years, subject to the same annual limitation.

Income-Shifting Techniques

Uniform Gifts/Transfers to Minors Accounts (UGMAs/UTMAs)

- Investment income in excess of $1,000 earned on gifts to children will be taxed to the child at the parent's tax bracket if the child is under 14 at end of calendar year, regardless of date of transfer.

Clifford/Spousal Remainder Trusts

- Investment income in excess of $1,000 earned on pre-March 1, 1986 gifts to children taxed at parent's tax bracket if child is under 14 at end of calendar year.
- Investment income earned on all other transfers made on or after March 1, 1986, taxed to the grantor.

1986 Strategies

- Maximize income shifting for balance of 1986 by investing in short-term, high income securities.

1987 Planning Recommendations

To avoid taxation at parent's rate, invest UGMA UTMA or pre-March 1, 1986 trust assets in:

- tax-exempt securities
- low or no income, high appreciation potential securities
- insurance products that provide for tax-deferred growth.

Q & A About Income Shifting

Q. Is all UGMA UTMA income subject to the restrictions imposed by the Tax Reform Act of 1986?

A. No, the new UGMA UTMA restrictions would only affect investment income in excess of $1,000.

Q. Are transfers to Clifford spousal remainder trust arrangements made prior to 1987 exempt from the new law?

A. No. Investment income in excess of $1,000 earned within these trusts on assets received prior to March 1, 1986 will be taxed at the parent's tax bracket if the child is under 14 as of the end of the calendar year. However, all income earned on *any* property transferred to *all* Clifford or spousal remainder trusts on or after March 1, 1986 will be taxed to the grantor.

Q. In light of these changes, are there any reasons to transfer property to UGMA UTMAs on behalf of minor children?

A. Yes. Although the new legislation substantially restricts the income tax benefits of UGMA UTMAs, these arrangements remain attractive for several reasons:

- gifts to children age 14 and over are not subject to these rules
- transfers may reduce potential estate tax liabilities
- funds are set aside for specific purposes, such as college tuition, at the discretion of the custodian while the child is a minor

Tax Investments

Major Changes

- Deductions for losses from tax investments limited to income from tax investments.
- Losses from working interests in oil and gas ventures remain fully deductible.
- Losses from real estate rental activities allowed to offset up to $25,000 of other income subject to phase-out as adjusted gross income exceeds $100,000.
- Investment tax credits repealed for property placed in service after December 31, 1985.
- Depreciation schedules revised for property placed in service after December 31, 1986, generally requiring machinery, equipment and real property to be written off over longer periods of time.
- Rehabilitation tax credits reduced to 20% for certified historic structures, and to 10% for buildings placed in service before 1936.

1986 Strategies

- Maximize tax savings by purchasing tax investments that produce substantial write-offs for 1986.
- Protect anticipated future losses from tax investments already owned by purchasing tax investments with projected taxable income.

1987 Planning Recommendations

- Monitor projected taxable income and losses from tax investments to optimize tax benefits.

Q & A About Tax Investments

Q. What types of tax investments are appropriate for 1986?

A. Because the restriction on the deductibility of losses from tax investments is not effective until 1987, substantial tax savings can still be realized by purchasing tax investments that produce substantial write-offs in 1986. Many of these investments are especially attractive because taxable income in future years will be available to offset losses from other tax investments that you may already own, in 1987 and thereafter.

Q. How are losses from tax investments treated after 1986?

A. Losses from tax investments are first offset against income from tax investments. In 1987, under a transitional rule, 65% of excess losses remain deductible against all other income. This percentage is decreased to 40% in 1988, 20% in 1989, and 10% in 1990. In 1991 and thereafter, excess losses would not be deductible, except against income from tax investments. Therefore, you should consider protecting these losses by purchasing tax investments with projected taxable income.

However, any excess losses not deductible in any year because of these limitations would be suspended and available to offset income from tax investments in any future year. When investors dispose of their entire interest in a tax investment, any remaining suspended loss incurred in connection with such an investment is allowed in full. Special allowances are available for losses incurred in rental real estate arrangements and certain oil and gas activities.

Q. How are losses from real estate rental activities treated after 1986?

A. There is a special provision that allows individuals who actively manage rental real estate investments to offset up to $25,000 of losses against other types of income. This allowance is phased out for those with adjusted gross incomes between $100,000 and $150,000. Thus, if an investor has adjusted gross income of $125,000 before considering rental activity losses, deductible losses from these rental activities would be limited to $12,500.

Q. After 1986, what type of tax investments remain attractive?

A. The provisions of the Tax Reform Act of 1986 shift the focus of tax investments from tax benefits to economic merits. Tax investments sold by Merrill Lynch have always been, in our view, solid economic investments. Although tax incentives are a major attraction of many of our tax investment products, the decision to market any product is based solely on economic viability.

Alternative Minimum Tax

Major Individual Changes

- Alternative minimum tax (AMT) rate increased from 20% to 21%.
- Preference items expanded to include deductible losses from passive investment activities, tax-exempt interest on private purpose bonds issued after August 7, 1986, and the appreciation in property contributed to charities.
- Exemption from AMT income of $40,000 for married couples ($30,000 for single taxpayers) to be phased out as alternative minimum taxable income exceeds $150,000 ($112,500 for single taxpayers).
- Long-term capital gains no longer generate preference income.

**1986 Strategies/
1987 Planning Recommendations**

- Monitor projected taxable income and preference items to determine whether potential AMT situation exists.
- If subject to the AMT, consider accelerating income to current year and postponing deductions.

Q & A About Alternative Minimum Tax

Q. What is the alternative minimum tax (AMT)?

A. The AMT is an alternate tax computation based on items that receive preferential treatment for tax purposes. Under current law, "tax preference" items include the 60% exclusion of long-term capital gains, certain deductions commonly incurred in tax investments, and the bargain element (fair market value minus option price) of an incentive stock option exercised during the year. If the AMT exceeds the regular tax, the AMT must be paid.

Q. How do investors know if they are subject to the AMT?

A. There are several situations that indicate potential exposure to the AMT. These include significant amounts of long-term capital gains (through 1986), substantial investments in "tax shelters" that generate tax preference income, the exercise of incentive stock options during the year, and, beginning in 1987, the receipt of tax-exempt interest income from private purpose bonds issued after August 7, 1986.

In terms of tax planning, it is extremely important to monitor an investor's exposure to this tax. Because of the complexity of this computation, Merrill Lynch has developed the AMT Planner. Ask your Financial Consultant for details.

Q. What strategies should be recommended to an investor who is subject to the AMT?

A. When an investor is subject to the AMT, all income, including tax preference items, will be taxed at 21%. Therefore, investors should consider generating ordinary income or claiming certain deductions that reduce the AMT. Investors subject to the AMT should consider the following strategies:

- Switch out of tax-exempt securities into taxable securities, including corporate bonds, common or preferred stock, mutual funds, Certificates of Deposit and U.S. Government obligations.
- Sell any securities that have short-term capital gains.
- Trade options in order to realize short-term capital gains.
- Redeem Series E or EE bonds to generate more ordinary income.
- Contribute cash or securities to a charitable organization. Securities held long-term and gifted to a charitable organization would give the donor a charitable contribution deduction for the fair market value of the gift. However, in 1987 and future years, the appreciation in property contributed to charities will be a tax preference item. Thus, investors should consider contributions of cash after 1986 to reduce exposure to the AMT.

Miscellaneous Provisions

- Personal exemption disallowed for an individual claimed as a dependent on another taxpayer's return.
- Income averaging repealed.
- Unemployment compensation fully taxable.
- Child dependent care tax credit retained.
- State and local income property tax deductions retained.
- Medical expense deductions limited to expenses which exceed 7.5% of adjusted gross income.
- Costs of attending investment conventions or seminars not deductible.
- Low-income rental housing tax credit enacted to attract investors.
- Political contributions tax credit repealed.

Business Taxation

Major Changes

- Effective July 1, 1987, corporate income tax rates reduced from a maximum tax rate of 46% to 34%.
- Effective January 1, 1987, corporate capital gains alternative tax rate increased from 28% to 34%.
- Owners of unincorporated businesses, including partnerships and sole proprietors, as well as S corporations, may benefit from the lowering of individual tax rates.
- Dividends-received deduction reduced from 85% to 80%.
- Investment tax credits repealed for property placed in service after December 31, 1985. The amount of unused investment tax credits that are carried forward from prior years will be reduced by 17.5% in 1987 and 35% in 1988.
- Depreciation schedules revised for property placed in service after December 31, 1986, generally requiring machinery, equipment and real estate to be written off over longer periods of time.
- Maximum annual elective deferral by an eligible employee is limited to $7,000 in 401(k) plans.
- Employee elective deferrals of up to $7,000 annually to certain Simplified Employee Pension (SEP) plans will be permitted.
- Key employees will no longer be permitted to deduct interest on loans from any qualified retirement plan.
- Business meals and entertainment deductions limited to 80% of expense.
- Alternative minimum tax preferences expanded to include one-half of "untaxed reported profits" and tax-exempt interest on private purpose bonds issued after August 7, 1986.
- Research and development tax credit reduced to 20% and extended through 1989.
- Interest deductions on business-owned life insurance restricted to interest on loans of $50,000 per employee.
- Tax deferral on earnings from annuity contracts held by corporations and other entities described as non-natural persons is eliminated.

1986 Strategies

- Cash basis taxpayers should defer income by delaying 1986 year-end billings and collections to the following year.
- Where appropriate, realize long-term capital gains in 1986.
- To offset income taxed at higher current rates, accelerate deductions in 1986.
- Purchase depreciable property in 1986, rather than 1987, for larger depreciation deductions.
- Monitor projected income to determine whether potential AMT situation exists.
- Maximize your retirement plan contributions for 1986, including possible catch-up contributions, to optimize tax deductions for your business and tax-deferred earnings for participants.

1987 Planning Recommendations

- Because 1988 tax rates will be even lower than the blended 1987 rates, it would be appropriate to postpone income into 1988 and thereafter, and to accelerate deductions in 1987.
- Because business interest expense remains fully deductible, continue to borrow, when appropriate, to help finance the growth of your business.
- Have your existing retirement plans professionally reviewed to assure that they will meet your objectives for 1987 and beyond.
- Consider the attractions of Simplified Employee Pension plans and non-qualified deferred compensation arrangements.

Q & A About Business Taxes

Q. How will corporations that do not report on a calendar year basis determine their tax liability for 1986?

A. The tax rates enacted by the Tax Reform Act of 1986 are fully effective for taxable years beginning on or after July 1, 1987. Corporations whose taxable year begins before July 1, 1987 will be subject to a blended tax rate that reflects current tax rates for the portion of the year prior to July 1, and the new rates for the balance of the year.

Q. Should corporations continue investing in dividend-paying stocks, despite the reduction of the dividends-received deduction?

A. Yes. The receipt of dividend income will be slightly more advantageous under tax reform as compared to current law. Although 20% of dividends will be taxable beginning in 1987, the maximum tax on dividend income will fall to 6.8% in 1988, based on a maximum corporate tax rate of 34%. This compares with 6.9% under current law (15% taxable portion of dividends times the maximum corporate tax rate of 46%).

Q. For purposes of the corporate alternative minimum tax (AMT), what is a corporation's "untaxed reported profits"?

A. The corporate AMT is designed to prevent profitable corporations from avoiding any significant current tax liability. For the most part, this is accomplished by treating one-half of untaxed reported profits as a tax preference item. The starting point for calculation of untaxed reported profits is net income as disclosed on the corporation's financial statements. This amount, referred to as "book net income," would include amounts exempt from Federal tax such as tax-exempt municipal bond interest and the dividends-received deduction. One-half of the excess of adjusted book income over AMT income is a tax preference item.

Your Merrill Lynch Financial Consultant can give you a copy of a brochure written especially for businesses. It's called *The Tax Reform Act of 1986: Financial Strategies for Businesses.*

Summary/Financial Planning Recommendations

The changes in the tax laws outlined in this brochure highlight the comprehensiveness of the 1986 tax reform legislation. The "1986 Strategies" will assist the investor in taking immediate steps to minimize the adverse effects and maximize the benefits available under current tax law. The "1987 Planning Recommendations" provide direction to the investor for future planning.

Investors should take the time to have their total financial plan reviewed. Although taxes should not be the only factor considered when developing a financial plan, they are an important consideration that should not be ignored if investors are to maximize their ability to attain their financial objectives.

Investors accumulate wealth through various means. Prudent selections within investment accounts is one method. Less apparent methods that are often neglected include the minimization of taxes, accumulation of wealth through employee benefit plans, the appreciation of personal assets including real estate, and the acquisition of assets such as insurance, which provide a minimum level of security in the event of death or disability.

An investor's financial picture includes not only the assets that comprise net worth, but the allocation and diversity of assets, as well as the plan in place for the distribution of those assets in the event of a major change in circumstance such as retirement, disability, or death.

Your Merrill Lynch Financial Consultant offers a wide array of services designed to provide financial management and review. Our Financial Pathfinder® service provides investors with an overview of their present financial position and makes recommendations to help the investor achieve his or her goals in light of the most current tax and investment planning strategies. The Pathfinder service is an excellent way to take an overall look at your financial situation. Your Financial Consultant can arrange to have a Pathfinder done for you.

In Conclusion

This brochure gives you the highlights of the Tax Reform Act of 1986 as it affects investors and suggests strategies for taking advantage of its benefits and minimizing its adverse effects. It is a general guide and you should consider any of the recommendations with your own tax advisor and in the light of your particular situation.

We urge you to begin your planning now so that you can take fullest advantage of the opportunities the Act creates. Your Merrill Lynch Financial Consultant will be happy to provide you with additional information and assistance that you might need to make tax planning decisions about investments.

Tax Tables

Source: Summary of Conference Agreement on H.R. 3838, prepared by the staff of the Joint Committee on Taxation dated August 29, 1986.

Personal Exemptions

1986	$1.080
1987	$1.900
1988	$1.950
1989 and thereafter	$2.000

Standard Deduction

	1986	1987	1988
Single	$2.480	$2.570	$3.000
Head of Household	$2.480	$2.570	$4.400
Married, filing jointly	$3.670	$3.800	$5.000
Married, filing separately	$1.835	$1.900	$2.500
Blind/Elderly (Single)		+ $750	+ $750
Blind/Elderly (Married)		+ $600	+ $600

Individual Tax Rates

Single

Income Bracket	Pay Base Tax of	Plus This Percentage of Amount Over Lower Bracket
1986		
Less Than $ 2.480	$ 0	
2.480	0	11%
3.670	131	12%
4.750	261	14%
7.010	577	15%
9.170	901	16%
11.650	1.298	18%
13.920	1.706	20%
16.190	2.160	23%
19.640	2.954	26%
25.360	4.441	30%
31.080	6.157	34%
36.800	8.102	38%
44.780	11.134	42%
59.670	17.388	48%
88.270	31.116	50%
1987		
$ 0	$ 0	11%
1.800	198	15%
16.800	2.448	28%
27.000	5.304	35%
54.000	14.754	38.5%
1988		
$ 0	$ 0	15%
17.850	2.678	28%
43.150	9.762	33%**
89.560	25.077	28%

**Surcharge of 5% for incomes between $43.150 and $89.560. For incomes over $89.560, a flat 28% rate applies to the entire taxable income. Personal exemptions are phased out for incomes in excess of $89.560 by applying a surcharge of 5% until all the benefits of personal exemptions have been totally offset.

Individual Tax Rates

Married Filing Jointly

Income Bracket	Pay Base Tax of	Plus This Percentage of Amount Over Lower Bracket
1986		
Less Than $ 3.670	$ 0	
3.670	0	11%
5.940	250	12%
8.200	521	14%
12.840	1.171	16%
17.270	1.879	18%
21.800	2.695	22%
26.550	3.740	25%
32.270	5.170	28%
37.980	6.769	33%
49.420	10.544	38%
64.750	16.369	42%
92.370	27.970	45%
118.050	39.526	49%
175.250	67.554	50%
1987		
$ 0	$ 0	11%
3.000	330	15%
28.000	4.080	28%
45.000	8.840	35%
90.000	24.590	38.5%
1988		
$ 0	$ 0	15%
29.750	4.463	28%
71.900	16.265	33%**
149.250	41.790	28%

**Surcharge of 5% for incomes between $71.900 and $149.250. For incomes in excess of $149.250. a flat 28% rate applies to the entire taxable income. Personal exemptions are phased out for incomes in excess of $149.250 by applying a surcharge of 5% until all the benefits of personal exemptions have been totally offset.

Married Filing Separately

Income Bracket	Pay Base Tax of	Plus This Percentage of Amount Over Lower Bracket
1986		
Less Than $ 1.835	$ 0	
1.835	0	11%
2.970	125	12%
4.100	260	14%
6.420	585	16%
8.635	940	18%
10.900	1.347	22%
13.275	1.870	25%
16.135	2.585	28%
18.990	3.384	33%
24.710	5.272	38%
32.375	8.185	42%
46.185	13.985	45%
59.025	19.763	49%
87.625	33.777	50%
1987		
$ 0	$ 0	11%
1.500	165	15%
14.000	2.040	28%
22.500	4.420	35%
45.000	12.295	38.5%
1988		
$ 0	$ 0	15%
14.875	2.231	28%
35.950	8.132	33%**
113.300	33.658	28%

**Surcharge of 5% for incomes between $35.950 and $113.300. For incomes over $113.300. a flat 28% rate applies to the entire taxable income. Personal exemptions are phased out for incomes in excess of $113.300 by applying a surcharge of 5% until all the benefits of personal exemptions have been totally offset.

Head of Household

Income Bracket	Pay Base Tax of	Plus This Percentage of Amount Over Lower Bracket
1986		
Less Than $ 2.480	$ 0	
2.480	0	11%
4.750	250	12%
7.010	521	14%
9.390	854	17%
12.730	1.422	18%
16.190	2.045	20%
19.640	2.735	24%
25.360	4.108	28%
31.080	5.709	32%
36.800	7.540	35%
48.240	11.544	42%
65.390	18.747	45%
88.270	29.043	48%
116.870	42.771	50%
1987		
$ 0	$ 0	11%
2.500	275	15%
23.000	3.350	28%
38.000	7.350	35%
80.000	22.250	38.5%
1988		
$ 0	$ 0	15%
23.900	3.585	28%
61.650	14.155	33%**
123.790	34.661	28%

**Surcharge of 5% for incomes between $61.650 and $123.790. For incomes over $123.790. a flat 28% rate applies to the entire taxable income. Personal exemptions are phased out for incomes in excess of $123.790 by applying a surcharge of 5% until all the benefits of personal exemptions have been totally offset.

Corporate Tax Rates

Income Bracket	Pay Base Tax of	Plus This Percentage of Amount Over Lower Bracket
1986		
$ 0	$ 0	15%
25.000	3.750	18%
50.000	8.250	30%
75.000	15.750	40%
100.000	25.750	46%
1.000.000	439.750	46% plus 5% on excess over $1.000.000 or $20.250 whichever is less

1987

New rates effective July 1. 1987. See page 12 for explanation of tax rates in effect for 1987.

Income Bracket	Pay Base Tax of	Plus This Percentage of Amount Over Lower Bracket
1988		
$ 0	$ 0	15%
50.000	7.500	25%
75.000	13.750	34%
100.000	22.250	39%*
335.000	113.900	34%

*Benefit of lower bracket taxation is phased out for income over $100.000.